

DILIGENCE

DILIGENTLY PURSUING EXCELLENCE



Wyndham Orlando Resort, Orlando

A Message from the Executive Director

December 15, 2006

Dear Friends:

As stewards of your retirement trust fund, TRS follows a consistent “due diligence” investment approach to assure that all contingencies are considered and all decisions are made with prudence and wisdom. Diligence is a part of our culture. Diligence leads to superior results in our investments, but equally important, in our service to members.

I am privileged to share an optimistic message with you. TRS members reported high satisfaction with our service, investment returns continued to rank in the top 25 percent of large public plans, and we continued to hold administrative

*Prefer diligence before idleness unless you esteem rust over brilliance.
~ Plato*

costs below other Illinois state-funded systems. Outstanding investment returns enabled an increase in our funded ratio, even though the state of Illinois reduced its contributions by \$524 million in an effort to balance the state budget. We work hard and we strive for the best, making apt our annual report theme, “Diligently Pursuing Excellence.” **The impressive buildings that illustrate this report are part of TRS’s real estate portfolio.** I hope you enjoy seeing tangible examples of our stewardship of your retirement funds.



Retirement Security for Illinois Educators

Pursuing the Best Each Time We Meet

Whether meeting members in the office, by telephone, or at one of our many field meetings, our member services personnel seek to provide the best service possible. Over 96 percent of members returning response cards rated our service “highly satisfactory.” A new telephone system has helped reduce the average wait time for a member service representative to less than one minute. TRS uses the very best technology that allows us to retain our commitment to personal service. Although implementation challenged our staff, improved service and options for future improvements made the effort worthwhile. Our commitment to service extends to the employer community, who were served by 14 regional seminars and 38 individual meetings.

Achieving Investment Excellence

As in seven of the past 10 years, TRS investments recorded double digit returns. The total return after all expenses was 11.8 percent in fiscal year 2006, compared to 10.8 percent in fiscal year 2005. This consistent performance once again placed TRS in the top quartile of large public funds in the Wilshire Trust Universe Comparison Service (TUUCS). This impressive record underscores the wisdom of our diversified investment approach. Noteworthy accomplishments include:

- Fund assets were \$36.6 billion, a 7.3 percent increase and an all-time high.
- As in five of the last six years, TRS was the best performing Illinois state pension fund.
- International equity produced an impressive 27.3 percent one-year return.
- Private equity provided a one-year return in excess of 20 percent for the second consecutive year. The 10-year return is 19.5 percent.
- TRS secured a \$13 million settlement for losses arising from the WorldCom bankruptcy.

Securing Legislative Accomplishments

Two legislative measures illustrate our diligence in securing needed legislation and assisting the General Assembly in its work. TRS worked productively to extend the 120-

day post-retirement employment limitation. Our assistance role culminated in the enactment of Public Act 94-1057, which exempts certain types of salary adjustments from the requirement that employers pay the additional pension cost of salary increases in excess of 6 percent.

Last year’s passage of Public Act 94-0004, which extended and modified the Early Retirement Option (ERO) and established new limitations on and contributions for certain sick leave and end-of-career salary adjustments, presented numerous challenges. TRS sought and achieved near-perfect consensus with all affected parties on rules to implement the legislation. Other challenges included adapting our information systems and providing up-to-the minute information to our members and their employers.

The TRS legal staff took a key role during negotiation of recently enacted changes in the QILDRO law to protect TRS interests. The law governs the division of public pension benefits in cases of marital dissolution.

Facing Challenges

As in life, TRS faced challenges and disappointments. Recent events involving a former trustee and a former outside counsel who breached the high standard we expect of those who serve TRS left us angered and disheartened. A sacred trust was betrayed. While the extensive media coverage makes an extended discussion unnecessary, I want to reassure you of three important points. First, at no time were any TRS assets used to fund illegal payments allegedly sought from current and potential TRS investment managers. Not one penny of TRS money was ever lost or put at risk by this scheme. Second, TRS has actively cooperated in the investigation, providing information, documents, and testimony. Finally, our investment process and the fundamental honesty of our staff, our current Board of Trustees, and the professional investment community proactively discourages and discovers such unethical behavior.

At TRS, we never consider our mission accomplished or our task completed. Rather, we work with diligence to better our record and improve our service.

Sincerely,



Jon Bauman
Executive Director

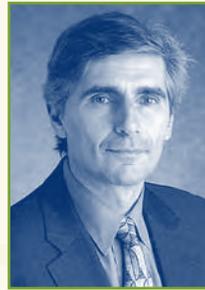
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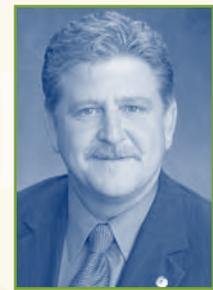
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Member Services

Condensed Comparative Statement of Plan Net Assets as of June 30

	2006	2005	Percentage Change
Cash	\$3,867,280	\$3,777,107	2.4%
Receivables and prepaid expenses	352,050,422	382,518,911	(8.0)
Investments	37,336,880,818	34,898,361,784	7.0
Invested securities lending collateral	4,401,016,409	4,386,594,663	0.3
Capital assets	2,333,759	2,320,275	0.6
Total assets	42,096,148,688	39,673,572,740	6.1
Total liabilities	5,511,259,261	5,588,354,263	(1.4)
Net assets	\$36,584,889,427	\$34,085,218,477	7.3%

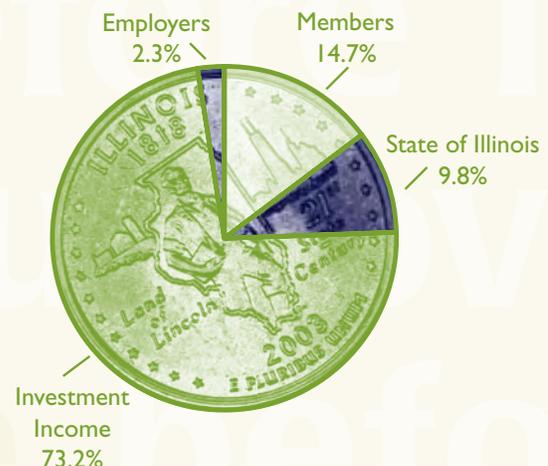
Condensed Comparative Statement of Changes in Plan Net Assets For the Year Ended June 30

	2006	2005	Percentage Change
Contributions	\$1,456,882,200	\$1,817,352,355	(19.8%)
Total investment income	3,993,289,880	3,330,039,158	19.9
Total additions	5,450,172,080	5,147,391,513	5.9
Benefits and refunds	2,935,197,760	2,592,498,606	13.2
Administrative expenses	15,303,370	14,403,715	6.2
Total deductions	2,950,501,130	2,606,902,321	13.2
Net increase in net assets	2,499,670,950	2,540,489,192	(1.6)
Net assets beginning of year	34,085,218,477	31,544,729,285	8.1
Net assets end of year	\$36,584,889,427	\$34,085,218,477	7.3%

Fiscal Year 2006 Financial Highlights

- TRS net assets at June 30, 2006, were \$36.6 billion.
- During fiscal year 2006, TRS net assets increased \$2.5 billion.
- Net assets are determined by subtracting liabilities from total assets. Most TRS liabilities involve securities transactions.
- Contributions from members, employers, and the state of Illinois were \$1,457 million, a decrease of \$360 million or 19.8 percent for the fiscal year. The decline is directly attributable to the reduction in state funding.
- Total investment income was \$3,993 million, an increase of \$663 million compared to fiscal year 2005.
- Benefits and refunds paid to members and annuitants were \$2,935 million, an increase of \$342 million or 13.2 percent compared to fiscal year 2005.
- The pension benefit obligation or total actuarial accrued liability was \$59.00 billion at June 30, 2006.
- The unfunded actuarial accrued liability increased from \$21.99 billion at June 30, 2005 to \$22.41 billion at June 30, 2006. The funded ratio increased from 60.8 percent at June 30, 2005 to 62.0 percent at June 30, 2006.
- The unfunded liability is the difference between the value of future pension benefits accrued minus the net assets currently available to pay these future benefits.

Contributions and Investment Income

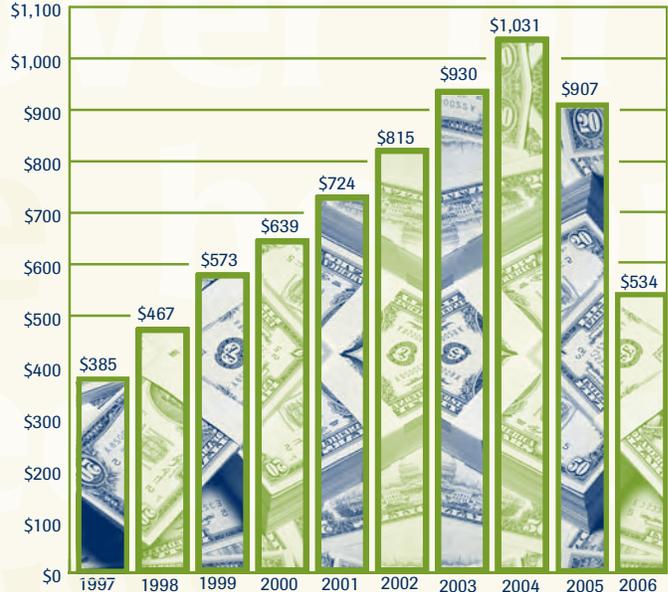


State Funding

The state of Illinois is the major source of funding for employer contributions. Beginning in 1996, the state adhered to a 50-year funding plan for nine successive fiscal years. In fiscal year 2005, the appropriation was reduced to recognize pension obligation bond proceeds. As shown on the accompanying chart, the funding plan changes resulted in a reduction in the contributions for fiscal year 2005.

The state decreased its TRS contributions by \$524 million due to budget difficulties in fiscal year 2006. The contribution amount set by law for fiscal year 2006 was about half the amount recommended by the actuaries to comply with the statutory 50-year funding plan. The amount appropriated for fiscal year 2007, \$738 million, is also set by law and not based on actuarial funding requirements. While the law purports to return to the ramp process specified in the original legislation, state funding requirements to return to the ramp are substantial. The ultimate goal of the funding plan remains at 90 percent funding by the year 2045.

State Appropriations (\$ in millions)



101 South Second Street, San Francisco

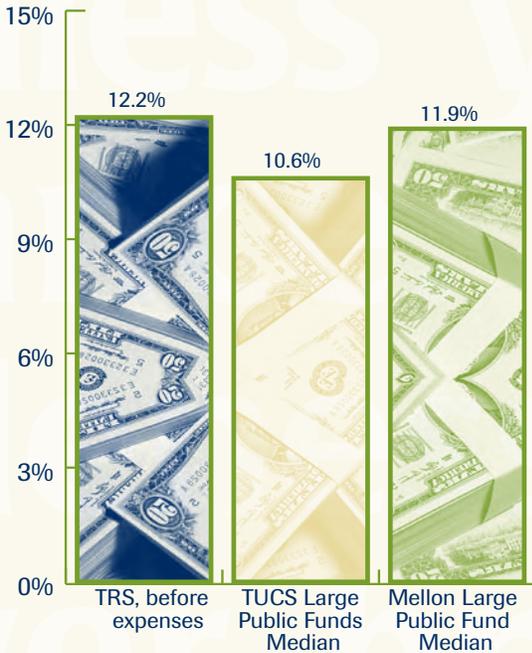
Investments

The TRS investment portfolio had another strong year, returning 12.2 percent, before expenses. This number follows a successful fiscal year 2005 performance of 11.1 percent, before expenses, as all asset classes again produced positive returns. Overall, the U.S. economy remained vibrant and inflation restrained, providing a healthy investment environment. Outside of the U.S., markets were even stronger with stock returns in the high 20 percent range led by continued expansion from emerging market economies. Substantial gains were accumulated in the private markets in fiscal year 2006 with the TRS private equity portfolio returning 23.8 percent, net of fees, and the TRS real estate portfolio generating an 18.8 percent return, after expenses.

The TRS investment portfolio continued to rank highly against its peers. Over the past 10 years, TRS ranks in the top quartile of the large public funds in the Wilshire Trust Universe Comparison Service (TUUCS).

As shown on the chart on page 6, the national organizations compare investment earnings before expenses. In addition, TRS also reports performance after expenses. The average return is reported for many different periods. For example, during the 20 years ended June 30, 2006, TRS earned a net return of 9.6 percent.

TRS Returns Compared to Other Large Public Funds*

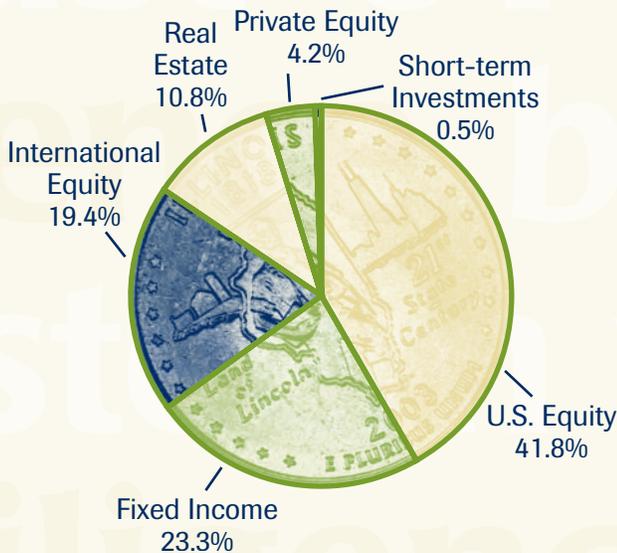


*The total return also surpassed the 8.5 percent actuarial return assumption and the real rate of return expectation, which is to exceed the rate of inflation, as measured by the Consumer Price Index, by 5.0 percent.

Investment Portfolio

The TRS investment portfolio is well-diversified and is shown in actual figures as of June 30, 2006, on the chart below. By investing in a broad range of asset classes, TRS minimizes risk and achieves more consistent investment returns.

Fiscal Year 2006 Asset Allocation



TRS Investment Performance (after expenses)

	1 yr	2 yrs	3 yrs	5 yrs	10 yrs	20 yrs
Rate of return	11.8%	11.3%	13.0%	7.9%	9.0%	9.6%

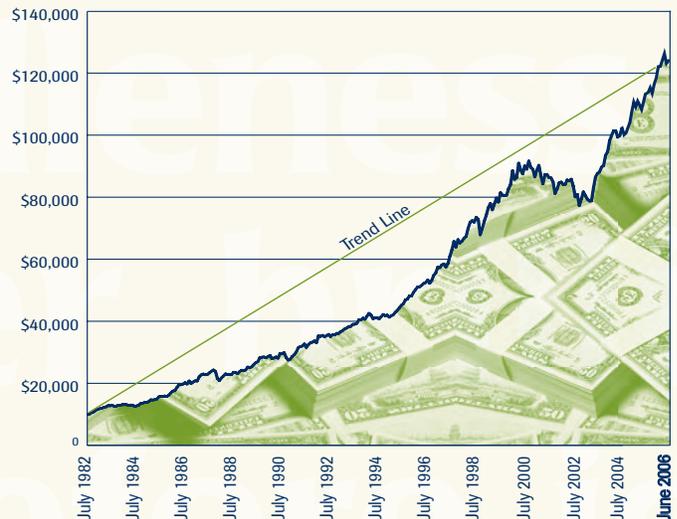
Top 10 U.S. Equity (Stock) Holdings

Firm	Market Value
General Electric Co.	\$226,825,051
Exxon Mobil Corp.	194,288,517
Citigroup, Inc.	176,535,775
Pfizer, Inc.	157,261,439
Hewlett-Packard Co.	126,546,932
Chevron Corp.	122,811,030
Microsoft Corp.	114,343,329
Comcast Corp.	112,716,715
Cisco Systems, Inc.	108,328,184
ConocoPhillips	99,137,323
Total	\$1,438,794,295

Source: The Northern Trust Company

Growth of \$10,000

Over the years, TRS's asset allocation has provided consistent overall returns, as represented by the following chart showing the growth of \$10,000 over the last 24 years. Despite the economic downturn in 2000 through 2003 and other market fluctuations, the overall trend line is solidly favorable.



Actuarial

In simple terms, a retirement system accumulates dollars today to pay future pensions and benefits when members retire or die. Each year, our actuary measures the value in today's dollars of the benefits earned by our members and the value of TRS investments available to pay current and future benefits. TRS investments improved the unfunded liability despite the \$524 million in state reductions.

Here are the key results of the current actuarial valuation compared to the prior year's valuation:

Actuarial Valuation (\$ in thousands)

	Years Ended June 30	
	2006	2005
Actuarial accrued liability	\$58,996,913	\$56,075,029
Net assets at market value	\$36,584,889	\$34,085,218
Unfunded liability	\$22,412,024	\$21,989,811
Funded ratio	62.0%	60.8%

Member Statistics

Full and Part-time Active Members

Average age	42
Average years of service	12
Average annual salary	\$56,916
Oldest full-time teacher	85

Retired Members

Average age	69
Average service	29
Average annual benefit	\$38,076
Oldest retired teacher	107

Funded Ratio



Olympic Block, Seattle

Fiscal Year Highlights

	2006	2005
Active (contributing) members	159,272	155,850
Inactive (noncontributing) members	81,218	87,328
Benefit recipients	<u>85,103</u>	<u>82,575</u>
Total membership	325,593	325,753
Actuarial accrued liability (AAL)	\$58,996,913,000	\$56,075,029,000
Less net assets held in trust for pension benefits	<u>36,584,889,000</u>	<u>34,085,218,000</u>
Unfunded actuarial accrued liability (UAAL)	\$22,412,024,000	\$21,989,811,000
Funded ratio (actuarial value of assets ÷ actuarial accrued liability)	62.0%	60.8%
Total fund investment return, net of fees	11.8%	10.8%
Expenses		
Benefits paid	\$2,877,230,697	\$2,533,102,848
Refunds paid	57,967,063	59,395,758
Administrative expenses	<u>15,303,370</u>	<u>14,403,715</u>
Total	\$2,950,501,130	\$2,606,902,321
Income		
Member contributions*	\$799,034,336	\$761,790,009
Employer contributions	123,542,608	148,813,036
State of Illinois contributions	534,305,256	906,749,310
Total investment income	<u>3,993,289,880</u>	<u>3,330,039,158</u>
Total	\$5,450,172,080	\$5,147,391,513

* Includes member payments and accounts receivable under the Payroll Deduction Program.

This publication is a summary of the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2006. The comprehensive report, which has more detailed information, is available at our Web site, trs.illinois.gov, or by calling (800) 877-7896.

